

Multi-stakeholder consultation on systemic issues organized by the New Rules for Global Finance Coalition in cooperation with the Financing for Development Office/UN DESA, at ANDEAN Community Headquarters in Lima, Peru from 17-18 February 2005

The second of a series of multi-stakeholder consultation on systemic issues organized by the New Rules for Global Finance Coalition in cooperation with the Financing for Development Office took place at ANDEAN Community Headquarters in Lima, Peru from 17-18 February 2005. The local co-organizer was the Asociacion Latinoamericana de Organismos para Promocion de Desarrollo (ALOP). The meeting was co-sponsored by the UN Foundation, Centro de Estudios y Promoción del Desarrollo (DESCO), Friedrich Ebert Foundation and the Swedish Ministry of Foreign Affairs. The meeting was preceded by a presentation of a report commissioned by the Swedish Foreign Ministry on “The Future of Development Financing: Challenges, Scenarios and Strategic Choices” on Wednesday, 16 February 2005.

The multi-stakeholder consultation itself was concerned with concrete proposals for reforming the International Financial Architecture (IFA) with a regional focus on Latin America and other middle income countries. Similar to the first consultation, the event was structured around the following sessions and topics:

- 1) Introduction and Overview
- 2) Review of Official Reform Agenda
- 3) Crisis Prevention
- 4) Credit in Times of Crisis
- 5) Reforming Governance of Global Institutions
- 6) Management of Capital Flows and Risk Exposure
- 7) Conclusion and Next Steps

What follows is a brief description of the presentations and discussions during each one of the sessions with a clear focus on issues, proposals and recommendations. Participants agreed that neither the identity nor the affiliation of the speaker(s), nor that of any other participant, would be revealed in any report, but the content of the discussions would be made public.

Session I: Introduction and Overview

The meeting started with a short introduction that highlighted the relevance of the multi-stakeholder consultations on systemic issues for the Financing for Development (FFD) follow-up process and explained some of the recent initiatives taken in this context, including a workshop on FFD at the World Social Forum in Porto Allegre. The opening remarks were followed by a presentation to set the Latin American context for the subsequent discussions.

The presentation highlighted the fact that the economic growth experience in 2004 in the Latin American region was impaired by a net loss of foreign capital, mostly due to the withdrawal of official flows from the international financial institutions (IFIs) and governments. The sustainability of this phenomenon was questioned, which would indicate low political interest on the part of official institutions in successful achievement of the Millennium Development Goals (MDGs) in the region. In order to reverse this tendency, civil society organization (CSOs) have

highlighted the need to enhance debt relief for middle income countries, as well as setting up international mechanisms for the arbitration for sovereign debt. Moreover, official development aid (ODA) should not only increase, but also be made more efficient through, amongst other things, a stronger civil society participation in its disbursement process. The need to democratize international financial institutions was also highlighted and pointed to the High-level Plenary Meeting of the sixtieth session of the General Assembly on September 2005 and the G8 meeting to take place in July as important lobbying opportunities for CSOs in this regard.

Discussion

In the ensuing discussion many participants expressed their concerns about the current US twin deficits and the potential impact on the stability of the international financial system. Capital flight and tax havens were also highlighted as major causes of net capital outflows from the developing world. On a similar note, the case of Chile was mentioned as an example of an ill-advised governmental subsidy on foreign natural resource exploitation. Despite a strong surplus in the mining industry, which made up for over 40 per cent of Chile's export revenues, no taxes were being collected from foreign companies that comprise the majority of the industry. Other participants highlighted domestic capacity building, stabilizing institutional policies, flexible exchange rates and export diversification as critical policy instruments in order to increase the development impact of capital inflows.

Session II: Review of Official Reform Agenda

In session II participants were encouraged to acquaint themselves with the outcome of the first multi-stakeholder consultation on systemic issues. A draft of the rapporteur's report on the first meeting was disseminated for this purpose.¹

Session III. Mechanisms for Crisis Prevention

The session was opened with a presentation on "A proposal for a new International Debt Framework for the prevention and resolution of debt crisis in middle-income countries". An International Debt Framework (IDF) was proposed that would present a middle ground between a legally binding insolvency procedure and a voluntary code of conduct. The proposal also departed from prior discussions of such mechanisms by locating it in the G20.² The proposed IDF would satisfy two needs of international financial stability: crisis prevention and crisis resolution. Permanent debtor-creditor dialogues, the provision of transparency, and information on emerging market debt would be ensured through the creation of a permanent IDF-Secretariat. An IDF Commission would aim for a coherent and comprehensive debt restructuring when requested to do so by the debtor country. It would also propose the amount of necessary financial support and an economic adjustment path that could guarantee long-term debt sustainability. These recommendations would then apply to all creditors.

¹ See "Draft Rapporteur's Report from the International Conference on Financing for Development Multi-Stakeholder Consultations on Systemic Issues" at <http://www.new-rules.org/docs/ffdconsultdocs/background021705.htm>.

² The G20 referred to here is comprised of Finance Ministers from the G7 plus "systemically significant countries; it is not the G20 associated with developing countries' joint negotiations at the WTO.

Discussion

The following discussion highlighted the merits and shortcomings of the IDF. Among the positive elements discussants referred to the comprehensive nature of the proposal, its political feasibility, improved impartiality (according to some participants the decision-making process was likely to be more impartial in the G20 than in the IMF), and the inclusion of the private sector through the Institute of International Finance, Inc. (IIF) in the process. Others, however, questioned the feasibility of this proposal as long as there was no significant policy shift in the current US administration. The fact that the G-20 was still a voluntary organisation at the Finance Minister level, rather than Heads of State/Heads of Government, was also considered a drawback. The need to coordinate the proposal with the Latin American initiative for an International Board of Arbitration for Sovereign Debt was also mentioned. Among the issues not sufficiently addressed in the proposals discussants highlighted collective action problems, the prevention of hostile litigation, the effectiveness of exit consents that would penalize bondholders who do not participate in the restructuring process, transparency requirements regarding prices of emerging market securities, and the inclusion of brokers and dealers to exclude hold-out problems.

Session IV: Credit in times of crisis

The presentation at this session was made on innovative forms of finance, with special reference to elements of the “Action Against Hunger and Poverty” or "Lula Initiative". Recent initiatives on innovative financing mechanism have been described as mere distractions from more relevant development issues. As most of the proposals had been around for decades it would hardly be appropriate to call them innovative. Neither could they be called feasible, in particular where the concept of international taxation was involved. Aid effectiveness in general was questioned as donors would often benefit more from it than actual recipient countries. The question should not be how more resources could be mobilized, but how less harm could be imposed on the developing world. Hence, policy initiatives should focus on removing agricultural subsidies in the developed world, tackling the adverse development impacts of commodity price fluctuations, as well as debt relief and debt restructuring.

Discussion

In the ensuing debate many participants challenged the bleak assessments of the presenter. It was pointed out, that the High-Level Panel on Financing for Development headed by former Mexican President Zedillo had called for an extra \$50 billion per annum to meet the Millennium Development Goals (MDGs) and that this was now generally accepted as a good estimate of the additional funds needed for that purpose. It was also clear that while some progress had been made by developed countries in setting target dates to meet the agreed UN aid target of 0.7 % of GNP, the increased official assistance would fall far short of the funds needed to meet the MDGS. The proposals put forward through the “Lula initiative” thus offered a “menu” of alternative financing mechanisms that could be used to supplement official assistance and allow them to honour their pledges. Some participants called the removal of agricultural subsidies in the developed world a desirable, but highly unrealistic, scenario as these subsidies were already capitalized in land values of developed countries and were used as collateral for borrowing from

the banking system. The removal of subsidies would not only cause a collapse in land values, it would threaten the stability of developed country financial systems.

Once more it was pointed out that for developing countries the prevention of tax evasion and capital flight could vastly increase domestic resources in addition to those brought about through new financing mechanisms. The discussion also ventured into the appropriate mix of stabilizing and growth-inducing policies imposed by IFIs on developing countries in times of crisis. It was emphasized that both macro and structural aspects had to be addressed in crisis scenarios and that more focus ought to be put on countercyclical policies. More specifically, the case of Chile was mentioned as an example where a good policy mix of flexible exchange rates, countercyclical fiscal policies and a “well-behaved”, independent central bank spurred economic growth and development in the late 1990’s.

Finally, some participants stressed the need to steer the discussion back to systemic aspects such as the need for transparency and access to information in derivatives market and questioned the relevance of the debate on innovative mechanisms in the context of the multi-stakeholder consultation on systemic issues.

Session V: Reforming Governance of Global Institutions

This session focussed on different approaches to reforming IFIs and stressed that reform proposals should go beyond “cosmetic efforts” and consider the structural resistance to reform. Conditionality was seen to be the critical starting point for reform. However, as long as there existed no alternative economic theory to the neo-liberal policies embraced by the Washington Consensus any such effort would be doomed to failure.

Discussion

While there was universal agreement that the voice and participation of developing countries in the IFIs should be increased, views differed on the most practical means to achieve this goal. Some participants focused on proposals to change the basic votes. Because the number of basic votes had not been changed with successive quota increases, the ratio of basic votes to total votes had declined significantly since 1945, thereby raising the relative voting power of larger countries. A revision of the basic votes could increase the decision-making power of developing countries and would not demand a change of the Articles of Agreement as the quota would be under control of the Executive Boards of the Bretton Woods institutions (BWIs). Another proposal to introduce a one-country-one-vote voting structure was met with scepticism and dismissed as unfeasible by many participants. Several participants pointed out the need for more coordination, coherence and cooperation. Calls were made for more transparency and accountability, which could be achieved through the inclusion of parliaments in the decision-making process.

Session VI: Management of Flows and Risk

This session was divided into two sub-sections.

The first section was on Prudential Market Regulation and Counter-Cyclical Policies. A strong domestic banking sector and sound macro-policies were identified as central prerequisites for the successful conduct of counter-cyclical policies. This would imply fiscal restraint, high levels of reserves, exchange rate flexibility, limited bank exposure to risk, the banks' availability of short-term liquid assets, the avoidance of under-capitalization, and the reduction of vulnerabilities during upswings of the business cycle. Also identified were the areas of macro-fiscal responsibility, inflation, flexibility of exchange rates, the financial system, financial supervision and transparency as the bases for Chile's ability to use counter-cyclical fiscal policy, which also stressed the use of controls on capital inflows. It was pointed out that inflation targeting based on a Taylor rule implicitly contained counter-cyclical policy since it includes references to the output gap. The efficiency of counter-cyclical policy in the context of an open economy was questioned outside its use in such a scheme.

Discussion

In line with the presentation several participants highlighted the need for sound institutions, a sound financial system, transparency of the banking sector and supervision thereof, as well as fiscal restraint and monetary policies based on inflation targets. Others, however, pointed out that fiscal restraints should not limit the room for manoeuvre for counter-cyclical policies. More specifically, it was highlighted that many developing countries have very limited counter-cyclical policy tools at hand due to conditions imposed by IFIs. One concrete proposal in this regard was to introduce asset price targets for central banks to prevent the occurrence of asset price bubbles. Other more general initiatives called for counter-cyclical prudential regulations, in the form of forward-looking provisions and the inclusion of social policy indices in the central bank's inflation targets.

In the second section on Foreign Borrowing in Local Currency Denominated Debt was proposed as a mechanism to improve the ability of developing countries to reduce their exposure to other countries' interest rate and exchange rate volatility and to lower their cost of raising capital abroad. Developing countries would borrow in their own currencies and investors lend by creating portfolios of local-currency government debt securities that employ the risk management technique of diversification. Historical estimates were highlighted showing that portfolio of domestic currency denominated emerging market debt, with equal weight to all countries, could generate rates of return relative to risk that competed with those of major securities indices in international capital markets.

Discussion

In the subsequent discussion some participants questioned the value-added of the proposed mechanism for Latin America as excess savings would already go towards government bonds. This was particularly true of pension funds that usually had constraints on their ability to invest in foreign currency denominated assets. It was also suggested that international depositary receipts could produce a similar result of isolating an issuer from flight by foreign investors. Others highlighted potential problems regarding its feasibility due to information time lags and adverse selection. While some pointed out that the combination of country and exchange rate risk implied in the proposal might be hard to sell to investors, others asserted that this type of

risk diversification would be one of the advantages of the proposal. It was also noted that any foreign exposure was subject to systemic risks. Participants agreed, however, that for the proposal to work local currency markets and broker-dealer networks needed to be strengthened and become more sophisticated.

Session VII: Summary and Closing

The meeting closed with a summary of the main points of discussion, as described here. The participants also were invited to send additional comments and feedbacks to the organizers, whether regarding the discussion at this meeting, or as suggestions for subsequent events in Nairobi and New York, or for the summary document containing formal recommendations. The organizers thanked all present for their contributions and on-going commitment to implementing the commitments made at Monterrey, Mexico. They also thank the Andean Community for their hospitality and for the excellent and endless work of the support staff.